



HB 827 – Revise Pension Plan for New Hires

The Public Employees' Retirement Board (PERB) respectfully opposes this legislation. The PERB is not against defined contribution (DC) plans in general. We currently have a DC option for Public Employees' Retirement System (PERS) members. However, designing a new system requires an in-depth study and analysis to ensure that the plan is viable, has minimum impact to the current plans and to ensure that the plan design will meet Internal Revenue Code (IRC) qualification requirements prior to implementation.

- ❖ House Joint Resolution No. 42 was passed in the 2005 Regular Legislative Session requesting that a legislative study be conducted on retirement funds. The State Administration and Veterans Affairs (SAVA) Interim Committee was charged with that task. During the interim, the SAVA Committee identified policy issues and concerns, developed principles and guidelines for reviewing legislative proposals and considered retirement plan options. The SAVA Committee did not propose a required DC retirement plan.
- ❖ Actuarial consultants for the Teachers' Retirement Board and the Public Employees' Retirement Board provided an analysis of several questions regarding the cost associated with conversion to a DC retirement plan. (Reference memo to *Senator Tropila* dated June 15, 2006.) Several issues that were raised in that analysis continue to be issues in the legislative proposal before you today.
- ❖ HB 827 creates a new DC plan for employees hired after the bill's effective date. The PERB has worked very hard to insure all plans they administer (including both defined benefit and DC plans) remain qualified under the IRC, and thus the members remain entitled to significant favorable treatment under the federal tax law.
- ❖ If the legislature wishes to move forward with a required new DC plan for new hires, we suggest that you expand the existing PERS-DCRP. Otherwise a study similar to the study performed before the current Public Employees' Retirement System – Defined Contribution

Retirement Plan (PERS-DCRP) was designed. Doing so would insure that other state retirement plan designs are analyzed and all issues are given adequate consideration.

- ❖ The timeframes in this legislation make implementation of the plan particularly onerous.
- ❖ Our tax consultants provide an initial analysis of the bill and concluded there were several problems, including problems that would make the plan unqualified. These IRC qualification issues should be addressed prior to plan design and implementation. (Reference *Ice Miller* memo dated March 22, 2007.)
- ❖ We also had our actuarial consultants provide us with an impact statement to the current Public Employees' Retirement System – Defined Benefit Retirement Plan (PERS-DBRP). (Reference *Milliman* memo dated March 20, 2007.)
- ❖ The current PERS Plan Choice election allows new hires to choose the appropriate plan for them. No one plan fits all sizes.
- ❖ Only 4% of PERS retirees have elected the PERS-DCRP. Studies indicate that approximately 6% of new hires in state plans choose DC.
- ❖ In DC plans, the contributions must be defined per IRC. This bill allows the employee contribution to be optional (zero up to the amount allowed by the IRC 415(c) contribution limits). Also, elective employee contributions are not allowed in a qualified governmental plan. Therefore, as proposed, this bill would not create a tax-qualified plan.
- ❖ Matching employer contributions are on a sliding scale (zero to 8%). This is not permissible under the IRC. DC plans are designed so that contributions go into the account and the investments help to grow the account balance. Employer contributions increasing in the later years does not allow for the account balance to compound in the early years.
- ❖ The funding rates computed as of July 1, 2009 may not be sufficient to actuarially fund the entire unfunded liability of the system by June 30, 2036, in the event that actuarial experience over the period is unfavorable. HB 827 does not appear to include a mechanism for funding of any actuarial losses in the defined benefit plans that might occur on or after July 1, 2009.

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- ❖ The bill allows members to make additional contributions for the purpose of purchasing various types of optional service credit but does not define optional service credit or the types of optional service credit members would purchase. Generally, DC plans do not provide service purchase options because the benefit received is the account balance; therefore, members' service is not part of the equation.
- ❖ The Information Technology Systems used to administer the DC plan would need to be modified to handle the transition to a DC plan for all new PERS and TRS public employees. Recent IT system designs completed in other states cost between \$6 million and \$12 million.
- ❖ Employers would also need to make changes to their payroll systems, a cost that is to be reimbursed by the retirement system with no adequate funding source provided. This cost is indeterminable and could be very large.
- ❖ Assuming the healthiest of the newest members work a maximum of 40 years and live 30 - 35 years after retirement, the PERBs' responsibilities devoted to the administration of DB plans would be minimal after 75 - 80 years. It could be as long as 50 years from now before the last current active member retires.
- ❖ Forfeitures, if any, may not provide any material funding toward making the systems actuarially sound during the period covered by this fiscal note.
- ❖ It appears that the Plan Choice Rate for the remaining closed group of DCRP and ORP members who established membership in those systems prior to July 1, 2009, will need to be increased if HB 827 passes. This is because the rate will apply to a decreasing payroll base instead of an increasing payroll base.
- ❖ The current Plan Choice Rate (PCR) would not be sufficient to amortize the PCR-UAL as scheduled. As of July 1, 2006, the maximum amortization period for the PCR-UAL is 18.75 years.
- ❖ A continuation of the 30-year funding may not be appropriate for a closed plan.

- ❖ There will be no new entrants in the PERS-DBRP, PERS-DCRP, Teachers' Retirement System (TRS) or the Optional Retirement Plan (ORP) on or after July 1, 2009. Through plan closures, HB 827 will decrease the number of future members participating in the systems and the total wages reported after July 1, 2009.
- ❖ Since the provisions of HB 827 would result in no new members of the PERS-DBRP or TRS on or after July 1, 2009, there will be no normal cost in the PERS-DBRP or TRS for new members on or after July 1, 2009.
- ❖ There would be no immediate impact on the Actuarial Balance Sheets. This is because there are no changes to the benefits of any current member.
- ❖ Employer contributions will need to increase by 5.32% to pay the current unfunded actuarial liability over a 30-year period, as required by the Montana Constitution.
- ❖ The amortization payment has been calculated as a percentage of payroll for the closed groups of defined benefit members producing a level rate as a percentage of the decreasing payroll of all active members over the remaining period.
- ❖ There would be significant contribution rate increases needed or some other type of additional funding required for the DB plans to make them actuarially sound as required by the Montana Constitution.
- ❖ Establishing a new retirement program involves a lot of planning and analysis. We suggest that the legislature consider expanding the current PERS-DCRP. At the very least, create a study including representatives from both retirement boards to discuss the issues and design a plan that is viable and is tax-qualified.
- ❖ The PERB recommends a "Do Not Pass" on this legislation.

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- ❖ The PERB recommends a "Do Not Pass" on this legislation.



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March 20, 2007

VIA E:MAIL

Ms Roxanne Minnehan, Executive Director
Montana PERA

**Re: Actuarial Impact Statement for Proposed 2007 Legislation
House Bill No. 827
Defined Contribution Plan for New Entrants in PERS**

Dear Roxanne:

The purpose of this report is to estimate the fiscal impact of proposed changes to Montana retirement law. The figures presented in this report have been estimated based on the findings in the 2006 actuarial valuations.

SUMMARY OF AMENDMENT

Our understanding of the impact of the provision of this proposal on the Retirement System's benefits or funding, based on our discussion with the MPERA staff, is as follows:

Statutes will be modified such that all new entrants on or after July 1, 2009 will become members in a Defined Contribution Plan.

The Board will have the authority to adopt schedules of contribution rates for the PERS DB plan such that the excess unfunded liabilities of the system will be paid in full within a period not to exceed 30 years.

We have not explored any legal issues with respect to the proposed changes. We are not attorneys and cannot give legal advice on such issues. We suggest that you review this proposal with your own counsel.

DATA, METHODS AND ASSUMPTIONS

These modified provisions will not directly impact the benefits of any current member. However, future active members will be impacted.

We have developed this analysis based on the data, methods, and assumptions contained in the actuarial valuations of the Systems performed as of June 30, 2006. In addition, we made the following assumptions with respect to this proposal:

- For purposes of this fiscal impact statement, we assumed that this is the only statutory amendment being considered. If other provisions are enacted, the



actuarial cost impact associated with this amendment may be different.

- We have not made any adjustment for actuarial gains or losses that may have emerged since the last valuation date, June 30, 2006.
- We assumed that there will be no new entrants in the MPERS Defined Benefit Retirement Plan (DBRP), MPERS DC Retirement Plan (DCRP), or the Optional Retirement Plan (ORP) on or after July 1, 2009.
- We have assumed that the Board will adopt a funding policy under Section 11 of HB 827 such that the entire unfunded actuarial liability excluding the PCR-UAL as of June 30, 2009 will be amortized by June 30, 2036 as a level percentage of payroll for the closed group of members who established membership in the system prior to July 1, 2009, if all actuarial assumptions are met over the period.
- It appears that the Plan Choice Rate for the remaining closed group of DCRP and ORP members who established membership in those systems prior to July 1, 2009, will need to be increased if HB 827 passes. This is because the rate will apply to a decreasing payroll base instead of an increasing payroll base. We have not analyzed the impact of HB 827 on the Plan Choice Rate.
- We assumed the plan changes in this legislation will not impact future patterns of retirement, termination of employment or any other actuarial assumption.

When a new plan of benefits is set up for future members, it is sometimes called a new "tier". The cost of the new tier may or may not be shared with the old tier. Based on the above assumptions, the salaries of the members of the Defined Contribution plan (the new tier) on or after July 1, 2009 are not considered in the amortization of the unfunded actuarial liability for the old tier. All unfunded actuarial liabilities will be funded over the payroll of the closed groups of members in the existing systems.

Based on the above assumptions, there would be significant contribution rate increases required for DBRP. In addition, without an increasing payroll base due to new members, the current "Plan Choice Rate" would not be sufficient to amortize the PCR-UAL as scheduled. The maximum amortization period for the PCR-UAL as of July 1, 2006 is 18.75 years.

If the Board adopts a funding policy as assumed above, the "excess unfunded actuarial liability" as defined in HB 827 will be equal to zero. The mechanisms in Section 17 of HB 827 would be inoperative under these assumptions.



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Ms. Roxanne Minnehan
March 20, 2007
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If the Board were to adopt a funding policy different from what we have assumed, there could be an "excess unfunded liability" as defined in HB 827. In that event the allocations described in Section 17 of HB 827 would need to be performed. The language of HB 827 is not clear as far as how these allocations should be performed.

We note that HB 827 does not appear to include a mechanism for funding of any actuarial losses in the DBRP that might occur on or after July 1, 2009. The funding rates computed as of July 1, 2009 may not actually be sufficient to fund the entire unfunded liability of the system by June 30, 2036 in the event that actuarial experience over the period is unfavorable.

FISCAL IMPACT

Based on our understanding of this proposal and the data, methods and assumptions outlined above, we have developed an estimated impact on the funding of each System based on the 2006 Actuarial Valuations as shown in the attached tables.

- There would be no immediate impact on the Actuarial Balance Sheets. This is because there are no changes to the benefits of any current member.
- Since the amendments would result in no new members of the DBRP on or after July 1, 2009, there will be no Normal Cost in the DBRP for new members on or after July 1, 2009.
- We have calculated an amortization payment as a percentage of payroll for the closed group of DBRP members producing a level rate as a percentage of the decreasing payroll of all active members over the remaining period. We used an effective date of July 1, 2009 for the change in the required contribution rates.

Based on our understanding of this proposal and the data, methods and assumptions outlined above, we have attached an estimated impact on the funding of the Systems, based on the 2006 Actuarial Valuations. Please refer to the valuation reports for more details about the data, methods, assumptions, and plan provisions used.

These cost estimates are subject to the uncertainties of a regular actuarial valuation; the costs are inexact because they are based on assumptions that are themselves necessarily inexact, even though we consider them reasonable. Thus, the emerging costs may vary from those presented in this letter to the extent actual experience differs from that projected by the actuarial assumptions.

Milliman's work product was prepared exclusively for MPERA for a specific and limited purpose. It is a complex, technical analysis that assumes a high level of knowledge concerning MPERA's operations, and uses MPERA's data, which Milliman has not audited. It is not for the use or benefit of any third party for any purpose. Any third party recipient of Milliman's work product who desires professional guidance should not rely



Ms. Roxanne Minnehan
March 20, 2007
Page 4

upon Milliman's work product, but should engage qualified professionals for advice appropriate to its own specific needs.


This analysis was prepared in accordance with generally recognized and accepted actuarial principles and practices which are consistent with the applicable Standards of Practice adopted by the Actuarial Standards Board of the American Academy of Actuaries. The undersigned is an independent actuary, a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, an Enrolled Actuary, experienced in performing valuations for large public employee retirement systems, and meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

Any distribution of this report must be in its entirety, including this cover letter, unless prior written consent is obtained from Milliman.

At your request, we have provided this DRAFT report prior to completion of our internal peer review. Because this is a draft, Milliman does not make any representation or warranty regarding the contents of the report. Milliman advises any reader not to take any action in reliance on anything contained in the draft report. All parts of this report are subject to revision or correction prior to the release of the final report, and such changes or corrections may be material.

If you have any questions or need further information, please let me know.

Sincerely,


Mark Johnson, F.S.A.
Consulting Actuary

MOJ:j mrs:l:072601a



Ms. Roxanne Minnehan
March 20, 2007
Page 4

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Consulting Actuary

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Montana PERA - Actuarial Impact Statement

Attached to Letter Dated March 20, 2007

Pension Fund Fiscal Note - PERS

DC Plan for New Members on or after July 1, 2009	2006 Actuarial Valuation	July 1, 2006 Results with Changes	Increase (Decrease)
Actuarial Balance Sheet (\$000)			
Present Value of Benefits	\$ 4,756,316	\$ 4,756,316	\$ 0
Future Normal Costs	<u>837,003</u>	<u>837,003</u>	0
Actuarial Liability	\$ 3,919,313	\$ 3,919,313	\$ 0
Actuarial Value of Assets	<u>3,459,084</u>	<u>3,459,084</u>	0
Unfunded Actuarial Liability	\$ 460,229 ⁽¹⁾	\$ 460,229	\$ 0
30-Year Funding Rates			
Normal Cost Rate	12.17%	12.17% ⁽²⁾	
Educational Fund	0.04	0.04	
30-Year Amortization	<u>2.60</u>	<u>6.91</u> ⁽³⁾	
Total 30-Year Funding Rate	14.81%	19.12%	4.31%
Resources			
Average Member Rate	6.90%	6.90%	
Employers	6.80	Unknown	
State of Montana	<u>0.10</u>	<u>Unknown</u>	
Total Contribution Rate	13.80%	19.12% ⁽⁴⁾	5.32%
Amortization Period July 1, 2006	Does not amortize	30.0 yrs.	

Notes:

1. Including the PCR UAL of \$18,754
2. The Normal Cost Rate for the closed group of members who established membership in the system prior to July 1, 2009
3. The amortization is calculated so that the total 30-year funding rate is a level percentage of payroll for the closed group of members who established membership in the system prior to July 1, 2009 over the period from July 1, 2009 through June 30, 2036.
4. Rate effective July 1, 2009 assumed to be established under Section 11 of HB 827.

At your request, we have provided this DRAFT report prior to completion of our internal peer review. Because this is a draft, Milliman does not make any representation or warranty regarding the contents of the report. Milliman advises any reader not to take any action in reliance on anything contained in the draft report. All parts of this report are subject to revision or correction prior to the release of the final report, and such changes or corrections may be material.



Milliman

This work product was prepared solely for the Montana Public Employees' Retirement Administration and may not be appropriate to use for other purposes. Milliman does not intend to benefit and assumes no duty or liability to other parties who receive this work.

MEMORANDUM

Teachers' Retirement System

1500 East Sixth Avenue
Helena, MT 59620-200139
(406) 444-3134

To: Senator Joe Tropila, Chairman, State Administration and Veterans' Affairs Interim Committee

From: David Senn, Executive Director, Teachers' Retirement System
Roxanne Minnehan, Executive Director, Montana Public Employees' Retirement Administration

Date: June 15, 2006

Subject: Cost associated with conversion to a defined contribution retirement plan

On May 2, 2006, on behalf of the State Administration and Veterans' Affairs Interim Committee, you requested from the Teachers' Retirement Board and the Public Employees' Retirement Board an analysis of several questions regarding the cost associated with conversion to a defined contribution retirement plan. While the questions did not lend themselves to specific actuarial determinations, we did work with our Actuaries to answer each question but also relied heavily on the expertise of others who have experienced such conversions or have direct experience with public plan conversions.

We would like to thank our Actuaries, Mark Olleman, Mark Johnson, and Keith Brainard, Research Director, National Association of State Retirement Administrators for their contributions to this report. These individuals are available to meet with the Committee if their expertise would be of assistance in evaluating the various plan designs and funding options under consideration.

c: David Bohyer, LSD Research Director
Teachers' Retirement Board
Public Employees' Retirement Board

State Administration and Veterans' Affairs Interim Committee

Reply to the SAVA Committee's Request for Analysis of the Cost Impact and Affect on Current Public Retirement Plans of a Conversion to a Defined Contribution Plan

Prepared by
David L. Senn, Executive Director, Teachers' Retirement System
&
Roxanne Minnehan, Executive Director, Montana Public Employees'
Retirement Administration

June 15, 2006

What would be the normal cost rate, i.e., what percent of payroll would be required to actuarially fund the normal cost? What does that amount to in dollars? How much of the total amount is payable by state government and how much by local governments?

Creation of a DC plan for all new members will not change the normal cost rate in the DB plans. In the future, the normal cost will increase or decrease based on the actuarial experience of the remaining closed group of members. The normal cost, unfunded liability contribution rate, the total rates, and required rate increase as of July 1, 2005 to actuarially fund the four systems with funding shortages are:

System	Normal Cost	Unfunded Liability	Total	Rate Increase
TRS	10.35%	4.38%	14.73%	4.06%
PERS ¹	12.12%	1.64%	13.80%	1.58%
SRS ²	19.45%	(0.67)%	18.78%	2.69%
GWPORS	18.56%	1.26%	19.56%	0.26%

The normal cost of the DC plan is equal to the contributions to the accounts plus any cost for supplemental death and disability benefits. The normal cost of the current PERS DC plan is 13.80%. The TRS Optional Retirement Plan normal cost rate is 12.0%

Assuming there are no other funding sources, the approximate percentage of the required contribution rate increase that would be paid by state and local governments for each retirement system is shown in the following table. The attached memo, dated December 3, 2005, from Jon Moe, Fiscal Specialist, to the Legislative Finance Committee, regarding the SAVA Committee's funding proposal, includes a table with the estimated fiscal impact of the proposed solutions. This legislation was prepared in anticipation that the 2005 Special Session Call would include actuarially funding the retirement systems.

¹ The PERS DB Plan includes an adjustment for potential changes to the DB Plan normal cost rate due to the optional nature of the current DC Plan. This is only necessary in optional arrangements because the older (more expensive) members, or those who expect to have a long career with the state, tend to elect the DB plan.

² The statutory funding rate is not sufficient to cover the normal cost, leaving nothing available to amortize the unfunded liabilities.

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PERCENTAGE OF THE EMPLOYER CONTRIBUTION RATE CONTRIBUTED BY STATE AND LOCAL GOVERNMENTS				
State Funding Sources	TRS	PERS	SRS	GWPORS
State General Fund	0.52%	14.56%	2.23%	65.80%
State Special	0.02%	13.64%	1.36%	28.01%
Federal	0.22%	9.59%	1.18%	1.77%
Proprietary	0.01%	5.17%	0.42%	0.26%
State Total	0.77%	42.97%	5.18%	95.84%
MT University System				
State General Fund	2.70%	2.19%		0.78%
Other	4.10%	7.67%		3.38%
U. System Total	6.79%	9.86%		4.16%
K-12 Schools				
General Fund	23.00%	2.89%		
County Levy	62.18%	7.82%		
Federal	7.26%	2.21%		
K-12 Schools Total	92.44%	12.93%		
Local Government		34.24%	94.82%	
Total Percent	100.00%	100.00%	100.00%	100.00%

What percent of payroll would be required to fund the unfunded actuarially accrued liability, if any? What does that amount to in dollars? How much of the total amount is payable by state government (all sources) and how much by local governments?

The simple answer is that the percentage would not change as a percentage of the total combined DB and DC payrolls. Creating a DC plan for new members does not change the systems' unfunded actuarially accrued liabilities. The only distinction is that the percent of payroll required to actuarially fund the systems would have to be contributed on all salaries, both DB and DC plan members. However, new members see this as a diversion of funds available to fund **their** benefits to the **old** DB plan.

Closing the DB plan to new entrants and increasing the percent of payroll contributed on the DB payroll only would result in a larger increase in the percentage of pay required to amortizing the unfunded liability, because it would be spread among a smaller and declining group of employees. It is not practical to finance the unfunded actuarial accrued liability as a percentage of a rapidly declining DB Plan payroll base, nor is it fair to require DC members to forgo contributions to their plan to fund the unfunded liabilities of the DB plan. A new funding source is needed before a new benefit plan is to be considered.

As an example, a situation like this already exists in Montana. All University faculty and administrators hired after 1993 have entered the Optional Retirement Program (ORP). The ORP is a defined contribution plan. Many members hired before 1993 are still in TRS. Supplemental contributions are made to TRS to finance the unfunded benefits of the University System employees who are still in TRS. The current employer supplemental contribution rate is 4.04% of the pay of all University employees in the defined contribution plan. However, the most recent actuarial study calculated a supplemental employer contribution rate of 5.09% of the pay for all members in the DC plan was required until 2033 to finance the unfunded benefits for University employees in TRS. As a result of the creation of the University System DC plan, University System employers currently contribute a total of almost 9.0% of salary compared to 7.47% paid by all K-12 and State employers participating in the Teachers' Retirement System.

The required actuarially unfunded liability contribution rates as of July 1, 2005 for all systems are as follows:

Underfunded Systems			Actuarially Funded Systems	
TRS	8.44%		MPRS	27.18%
PERS	3.22%		FURS	31.67%
SRS	4.71%		HPORS	23.25%
GWPORS	1.26%		JRS	0.00%

What is the estimated total cost of the transition from the defined benefit plan to the defined contribution plan?

The following is a list of historical cost incurred by the MPERA to implement the Public Employees' Retirement System – Defined Contribution Retirement Plan (PERS-DCRP), together with a few thoughts on other factors impacting the cost of administering either a DB or DC plan.

Closing the DB plan to new entrants and increasing the percent of payroll contributed on the DB payroll only would result in a larger increase in the percentage of pay required to amortizing the unfunded liability, because it would be spread among a smaller and declining group of employees. It is not practical to finance the unfunded actuarial accrued liability as a percentage of a rapidly declining DB Plan payroll base, nor is it fair to require DC members to forgo contributions to their plan to fund the unfunded liabilities of the DB plan. A new funding source is needed before a new benefit plan is to be considered.

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- Prior to implementation of the PERS-DCRP, an actuarial study was performed to determine the impact to the defined benefit plan. The study determined the disability cost and the plan choice rate. Today, this study could cost between \$25,000 and \$40,000.

The legislature approved a \$1.5 million loan for the implementation of the PERS-DCRP plan. We anticipate any additional start-up costs of at least this amount would be incurred if all new public employees were required to participate in the PERS-DCRP.

- There would also be ongoing costs associated with investment consultant reviews, monitoring and fund replacement searches. These ongoing costs for the PERS-DCRP in Fiscal Year 2006 were \$29,000. To assist the Board with the administration of the PERS-DCRP an Employee Investment Advisory Council (EIAC) was also established which meets quarterly. The consultant presents to the EIAC and EIAC then makes fund recommendations to the Public Employees' Retirement Board.
- As part of the implementation of the PERS-DBRP, the legislature recognized the need for a comprehensive education program that accounts for individual learning styles. Legislation was passed to build up an education fund in the PERS – 0.1% of employer contributions for three years and 0.04% each year thereafter. The contract for the initial plan-choice transfer education campaign was \$1.7 million. MPERA staff provided an employer education campaign first. Employer education was crucial to gain employer support and their encouragement to allow employees to attend the plan choice workshops on work time. The professional consultants worked with MPERA staff to devise a program, create multi-media education materials and provided multiple trainers across the state. The plan choice workshops ran until the end of the election window. If current PERS-DBRP members and all current defined benefit members were given a second election, the costs would be substantially greater.
- The Information Technology Systems used to administer the PERS-DCRP would need to be modified to handle the transition to a defined contribution plan for all new public employees. Recent IT system designs completed in other states cost between \$6 and \$12 million.
- New hire workshops are currently on-going and presented by two full-time in-house instructors who travel across the state. In 2006, the DBRP-DCRP Educational Program cost \$242,701.

- The new plan design will need to be approved by the Internal Revenue Service at a cost to each plan. This task requires the services of an attorney specializing in public plan compliance, and can cost between \$10,000 and \$20,000 depending on the complexity of the plan design.
- If all new employees are mandated to join the defined contribution plan, intense long-term investment planning workshops will also be needed by trained, certified investment counselors. The cost for these services across the state would probably exceed \$1million/year. The alternative is to have the money professionally managed.

Michael Barry, president of Plan Advisory Services Group, in the May 2006 issue of PLANSPONSOR states, "This argument - that DB plans cost too much - has some serious flaws. At the simplest level, the obvious fact is that they cost what they cost, just like DC plans. You can have a DB plan with a rich benefit that costs a lot of money, or one with a "less rich" benefit that doesn't cost so much. At a more subtle level, you can make a good argument that DB plans in fact, cost less than equivalent DC plans."

Two reasons stated in the article for DB plans costing less than DC plans were, first, because you are not keeping track of thousands of participant accounts and reporting them on a daily basis; and in managing DB assets, you can exploit economies of scale not available to DC plans. Second, you can bring more professional management to bear on the investment of DB plan assets. At large corporations, DB plans outperform DC plans by around 125 basis points (1.25%).

In what year would the unfunded actuarially accrued liability be paid off?

Assuming the 2007 Legislature approves increased funding sufficient to amortize the unfunded actuarially accrued liabilities over thirty years and that all actuarial assumptions are exactly met over the next thirty years, the unfunded actuarially accrued liabilities will be paid off in 2037.

Further study by our actuaries will be required to determine if it is appropriate to retain the 30-year funding strategy for the closed plans. It is generally accepted that the financing of the unfunded actuarial accrued liability is acceptable over a generation of workers, such as 30 years as long as new members continue to participate. If the plan is closed, there will be some point in the future when a 30-year amortization period will be inadequate.

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In what year would the TRB and MPERA most likely be able to stop administering benefits for (DB) members?

Assuming the healthiest of the newest members work a maximum of 40 years and lives 30 - 35 years after retirement, the Boards' responsibilities devoted to the administration of DB plans would be minimal after 75 – 80 years. It may be possible to purchase annuities from an insurance carrier prior to this date, however, this final transfer of risk could not occur until the last active member retires and the benefits are known. It could be as long as 50 years from now before the last current active member retires.

Our actuaries provide service to a large California municipality, which closed its public safety pension plan to new entrants in the 1970's. The last active member just retired in 2006 and there are still many retirees and beneficiaries receiving retirement payments.

What other effects or consequences are likely to occur as a result of the transition?

- Lower investment returns are likely for individual DC members as opposed to the DB plans as a whole. Historical statistics between defined benefit and defined contribution plans indicate better average investment returns in defined benefit plans. DB plans are better suited to real estate, private placements, and other types of diversified investments that can enhance long-term performance. Additionally, asset allocation by individuals tends to be more conservative and less disciplined. This is true for a several reasons, but primarily because the individual members are not investment experts; thus producing lower long-term returns of 1 to 2 percent less than a large professionally managed DB plan.
- The administrative cost of DC plans is approximately 100 basis points, or one percent, higher than a large DB plan. This one percent is normally paid by plan participants, resulting in a significant reduction over a lifetime in investment earnings. This higher administrative expense coupled with generally smaller investment returns of a DC plan, are major factors in making DC plans less efficient retirement vehicles, i.e., smaller DC plan balances ultimately are available to pay retirement benefits than with a comparable DB plan.
- Increased poverty in retirement for those not able to manage their own money effectively is likely. Many people are not knowledgeable about how to make their savings last a lifetime. Other factors leading to DC plans' reduced efficiency are the high percentage of participants who "cash-out" upon termination or exhaust their retirement assets before death.

- In California, an attempt last year to abandon defined benefit plans ran into a roadblock due to inadequate preparation and planning for death and disability provisions. Defined contribution plans cannot provide the same level of coverage for these ancillary benefits, particularly for younger members.
- A broad sweeping change for all of the Montana pension plans ignores the historical policy considerations for the specific needs of individual groups. For example,
 - Public safety pension plans generally provide for earlier retirement eligibility due to historically shorter careers for members on the front lines,
 - Judicial retirement plans generally provide a higher benefit per year to attract qualified attorneys to the bench later in their careers, and
 - Defined contribution plans for volunteer firefighters would need to be designed differently, if it would even be possible.
- The legislature will not have actuarially funded the four underfunded retirement systems as required by the Montana Constitution. Closing off the existing DB plan does nothing to help fund current unfunded liabilities.
- Switching to a pure DC plan may diminish the ability of public employers in the state to retain the personnel needed to continue to provide essential public services while reducing the overall retirement security of the state's workforce.
- There will be an increased need for investment education. It is difficult to get many members to participate in these programs. Regardless of how much investment education members receive, they will still have a lower level of expertise than the professional investment consultants who assist statewide defined benefit plans with their asset allocation and other strategic decisions.
- The benefits of longevity pooling will be lost, and there will be a greater risk of "outliving your assets." Defined contribution members need to make their assets last a lifetime. Currently about 50% of the men retiring at 65 will live to 83. Defined benefit plans can provide more benefits to the 50% of members who live past 83, because the other 50% are dying before 83. In a defined contribution plan all individuals need to plan for a long life.

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What other effects or consequences could potentially occur as a result of the transition?

- A future return to a defined benefit plan is possible. The State of Nebraska had a defined contribution plan for its State & County employees since 1964. In 2003, they went back to a hybrid defined benefit plan called a "Cash Balance" plan.

At the time of the change two reasons cited were: "On average, the DB investment returns in the School Employees, State Judges and State Patrol defined benefit plans were 11% for the past 20 years while state and county employees participating in the DC plan returned between 6% and 7% on average." Retirement replacement income was projected to be 50% - 60% for the DC plan members when the plan was adopted, but was closer to 30%.

Despite ongoing efforts to educate plan participants on the importance of asset allocation, not "cashing out" retirement assets when terminating, and not spending all retirement assets upon retirement, a benefits adequacy study (accessible here: <http://www.nasra.org/resources/nebraskastudy.pdf>) found that plan participants were significantly less prepared financially for retirement than their public employee counterparts in surrounding states. The study also found that a large percentage of participants allocated a significant percentage of their retirement portfolio to low-yielding stable value funds, which produced little in the way of investment returns.

In an interview with Ronald L. Hawkins and associate with Lussier, Gregor, Vienna & Associates, the director of the Nebraska PERS, Anna Sullivan stated, "Our experience has really proven that a DC plan may be good as a supplemental plan but is not good for the entire pension. This experiment, if you want to call it that, 30 years later, has not worked."

Similarly, in 1991 West Virginia closed its defined benefit plan to newly hired public school teachers because the plan was seriously underfunded. In 2005, the state actuary informed the legislature that it could reopen the DB plan to school teachers at the same or less cost as the DC plan. The legislature, perceiving that the DC plan was providing insufficient retirement assets for its participants, agreed and effective last year reopened the DB plan to newly hired school teachers. Earlier this year, the teachers who were in the DC plan (those hired between 1991 and 2005) voted by 61-39 percent to move en masse to the DB plan. (This election is currently being challenged by several participants who do not wish to have their retirement assets moved to the DB plan.)

- Long term costs, including public assistance could increase. Standard & Poor's published an article in 2005 titled "Public Employers are Exploring a Switch to Defined Contribution Pension Plans." The article stated, "There is a great deal of uncertainty in expected replacement ratios from DC plans. The employer who switches to DC from DB might enjoy lower pension contribution costs over the medium term, but could end up with higher public assistance costs in the long term."
- A conversion to a DC plan may adversely impact the State's credit rating. The same Standard & Poor's article concluded: "From a credit perspective, a DC conversion plan cannot be automatically considered a positive factor in that the effects must be weighed over a very long period. The benefits of a conversion to a government's cost structure in the early years could be undone in the later years if retiree income expectations are not realized and unexpected costs show up elsewhere."

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MEMORANDUM

TO: Montana Public Employees' Retirement Administration
(Roxanne Minnehan and Melanie Symons)

FROM: Ice Miller LLP (Mary Beth Braitman and Terry A.M. Mumford)

DATE: March 22, 2007

RE: HB 827 – DC Bill

HB 827 creates a new defined contribution plan for employees hired after the bill's effective date. As you know, the Montana PERA Board has worked very hard to insure all plans they administer (including both defined benefit and defined contribution plans) remain "qualified" under the Internal Revenue Code ("IRC"), and thus the members remain entitled to significant favorable treatment under the federal tax law. We are offering these comments assuming that the Board's position and commitment with respect to the plans and members will continue.

<u>Section</u>	<u>Provision</u>	<u>Ice Miller LLP Comments</u>
Section 9	Allows members to contribute up to maximum amount under IRC 415(c)	Elective employee contributions are not permitted on a tax sheltered basis to a qualified governmental plan. This section creates an impermissible cash or deferred (401(k)) plan. IRC § 401(k)(4)(B)(ii). Treas. Regs. § 1.401(k)-1(a)(1) and (2).
Section 10	Matching employer contributions are established based on years of service. Provides for disbursements of excess amounts.	A qualified defined contribution plan cannot have an "excess amount" which is then transferred to another plan. This creates a violation of the exclusive benefit rule. IRC § 401(a)(1) and (2).
Section 11	Provides for employer contributions for excess unfunded actuarial liability.	It is not clear in Section 11(3) where these contributions are made, but it could not be to the new plan. Section 15(2)(b) seems to say these contributions are made to the new plan.

<u>Section</u>	<u>Provision</u>	<u>Ice Miller LLP Comments</u>
Section 16	Allocating forfeitures to pay unfunded actuarial liability.	Same issues as noted above. (Note: we have not addressed the calculation of the excess unfunded actuarial liability – but we are puzzled by the intended calculation under Section 17(2)(b).)
Section 22	Provides for refunds and lump sum payments.	New federal laws require automatic rollovers of mandatory distributions of more than \$1,000. IRC § 401(a)(31)(B).
Section 24	Establishes implementation schedule.	Given numerous problems identified, implementation should be delayed until IRS issues favorable determination letter. <u>See</u> Sections 23 and 26.
Section 28	Provides for loan for administration.	We have concerns about the way this loan would be repaid.
Section 53 (Amendment to 19-20-302)	Allows for certain elections on part of county superintendents.	IRS seeking to severely limit amount of choice. <u>See</u> Treas. Regs. § 1.401(k)-(a)(3)(v).

CIRCULAR 230 DISCLOSURE: Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing or recommending to another party any tax-related matters addressed herein.

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